

Overdraft/Bounced-Check Protection

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Summary

Overdraft protection programs are an optional service offered by financial institutions to consumers. These programs are often referred to as “bounced-check protection” or “courtesy overdraft protection” to distinguish them from the more traditional overdraft lines of credit. Participating institutions cover checks drawn on accounts with insufficient funds and charge a fee. Financial institution representatives state that these programs offer a beneficial service to their customers by covering checks that would otherwise be returned unpaid. Consumer advocates argue that these programs are high-cost credit products that are marketed to vulnerable consumers, and that their main purpose is to increase fee income for banks.

Federal regulators have monitored the development of overdraft protection programs to ensure that adequate consumer disclosure is being provided and to measure the risk exposure for financial institutions. Several actions have been taken. In February 2005, federal regulators of the banking industry issued guidance concerning bounced-check/overdraft protection services offered by insured depository institutions. The Federal Reserve amended its Regulation DD (Truth in Savings) in May 2005 to address concerns about the adequacy and uniformity of consumer disclosures relating to overdraft services offered by depository institutions, including the advertising of these services. On December 18, 2008, the Federal Reserve announced additional amendments to Regulation DD. The changes aim to facilitate consumer understanding of how overdraft services operate and the costs associated with these programs. On November 12, 2009, the Federal Reserve announced amendments to Regulation E (Electronic Fund Transfers) that provide consumers a choice regarding their institution’s payment of overdrafts for automated teller machines (ATMs) and one-time debit transactions. Such payments would be prohibited unless the consumer affirmatively “opts in” or agrees to this type of overdraft protection.

Legislation in the 111th Congress (H.R. 1487, H.R. 3904, and S. 1799) would provide enhanced consumer protections for overdraft protection programs. This report will be updated as events and legislation warrant.

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Background

Traditionally, when a bank customer writes a check on an account that does not have sufficient funds on deposit to cover the amount of the check, he or she is charged a nonsufficient-funds (NSF) fee as a penalty. The check would be returned unpaid to the merchant or other third party. The customer could be charged another fee by that third party. The management of a financial institution does have the discretion to cover the overdraft (not return the check) and charge an overdraft fee. Consumers can often make an arrangement with their bank for an overdraft to be covered by funds held in another account the consumer holds with the institution (e.g., a savings account).

Financial institutions have offered overdraft lines of credit for protection against account overdrafts. A customer must apply for this credit product and meet creditworthiness criteria set by the institution. The lines of credit are subject to the disclosure requirements of the Truth in Lending Act (TILA)¹ implemented by Federal Reserve Regulation Z. Lines of credit usually charge an annual interest rate (generally around 18% to 20%) and allow repayment as the customer chooses within the terms of their agreement with the institution.

A more recent option for consumers is the bounced-check protection or courtesy overdraft protection service. These services vary among institutions but most share basic terms and conditions. Participating institutions offer this type of overdraft protection as a feature of their accounts, and customers do not have to apply and qualify for the service. An account normally qualifies if it has been open for a specified period and if there are regular deposits to the account. Commonly, consumers who meet the criteria are automatically enrolled in the overdraft protection program. A flat fee (generally the bank's standard NSF fee) is charged each time an overdraft item is covered, and a daily fee may be charged for each day the account remains overdrawn. Usually a ceiling is set for overdraft coverage. The service may extend beyond check transactions to other transactions, including withdrawals at automated teller machines (ATMs), online banking, pre-authorized automatic debits from a consumer's account, telephone-initiated funds transfers, and debit card point of sale transactions. A specified time period may be set for overdraft repayment. Some institutions offer closed-end loans to customers who cannot meet the repayment deadline. Most programs are offered with the caveat that payment of an overdraft is discretionary on the part of the institution and, therefore, the institution may not pay all the overdrafts that customers incur.²

Legislation and Ongoing Concerns

Bounced-Check/Overdraft Protection Legislation

Currently, three bills address overdraft protection programs in the 111th Congress: H.R. 3904, the Overdraft Protection Act of 2009; H.R. 1487, the Overdraft Fee Notification Act; and S. 1799, the FAIR Overdraft Coverage Act. The bills would enhance consumer protection by increasing consumer knowledge and awareness of overdraft programs and facilitating the ability of consumers to accept or decline overdraft services.

¹ 15 U.S.C. 1601.

² For additional information on overdraft protection programs, please see *Bank Fees: Federal Banking Regulators Could Better Ensure That Consumers Have Required Disclosure Documents Prior to Opening Checking or Savings Accounts*, GAO Report 08-281, January 14, 2008, at <http://www.gao.gov/new.items/d08281/pdf>.

Representative Carolyn B. Maloney has introduced several overdraft protection bills. The most recent version (H.R. 3904) is nearly identical to the current Senate legislation (S. 1799). S. 1799 was introduced on October 19, 2009, by Senator Dodd and others, and referred to the Senate Committee on Banking, Housing, and Urban Affairs. H.R. 3904 was introduced on October 22, 2009, by Representative Maloney and others, and referred to the House Committee on Financial Services. Hearings were held on both bills. The House Committee on Financial Services held a hearing on October 30, 2009. The Senate Committee on Banking, Housing, and Urban Affairs held a hearing on November 17, 2009.

The legislation would amend TILA to extend its coverage to overdraft protection programs. Fees associated with these programs would be considered finance charges. The legislation would prohibit unfair and deceptive marketing practices. Institutions would be required to inform customers of the different overdraft services and products offered by the institution. Account holders would have to opt in, provide their consent in writing, electronic form, or such other form as permitted by regulation, to an agreement detailing terms and conditions before being enrolled in overdraft coverage programs. Customers would be warned of a potential overdraft before completing a transaction at the branch teller or the ATM. Customers would be notified about an overdraft charge on the same day the charge was incurred. Periodic statements would contain information on overdraft fees charged both for the statement period and year-to-date.

Both bills would place limits on overdraft coverage fees. Overdraft fees would be limited to one a month and no more than six a year. Fees would be required to be proportional to the cost of processing the overdraft. The bills would prohibit institutions from manipulating the process of posting transactions against an account to increase the account holder's overdraft fees. Provisions would prohibit financial institutions from charging an overdraft fee if the overdraft results solely from a "debit hold" amount placed on an account that exceeds the actual cost of the purchase. Finally, the Government Accountability Office (GAO) would be required to study the feasibility of providing "real time" warnings of potential overdrafts at point-of-sale terminals.

H.R. 1487 was introduced on March 12, 2009, by Representative Kendrick B. Meek, and referred to the House Committee on Financial Services. No further action has been taken on this legislation. This legislation would require financial institutions offering overdraft protection services for ATM, point-of-sale, online, telephone initiated, and in person transactions to provide a warning notification when an overdraft fee will be imposed and to include the amount of the fee. This bill would require "real time" account balance notification that a transaction the consumer was in the process of initiating would trigger an overdraft fee and provide the consumer with the choice of terminating the transaction.

Industry Issues

Industry representatives have expressed general opposition to overdraft protection legislation. Their position presented, at the hearings,³ was that the actions taken by federal banking regulators concerning bounced-check/overdraft programs would continue to provide consumers with adequate disclosure and protection. Also communicated in industry testimony was the position that the additional TILA disclosure requirements and program restrictions proposed by the legislation would impose considerable costs and would likely result in the discontinuance of this

³ Please see the testimony of Nessa Feddis, vice president and senior counsel, Center for Regulatory Compliance, American Bankers Association, and John Carey, chief administrative officer, Citibank NA. Testimony presented at the hearings can be found on the two committees websites at http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr_102309.shtml and <http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.ByMonth&DisplayDate=11/17/09>.

beneficial service for many consumers. In addition, transmitting the notifications required by the legislation at electronic terminals would necessitate potentially prohibitive technical changes to the terminals and software. Financial institutions have worked to make it easier for a consumer to check an account balance online or by telephone, but providing “real time” account balance information presents difficult challenges. Industry representatives argue that the consumer is in the best position to know if authorized but possibly not yet processed (cleared) transactions would change the balance provided by the bank. If an account holder carefully keeps track of all his or her transactions (including checks, debit card purchases, and preauthorized automated payments), then the account holder has the best information to avoid overdrafts.

Consumer Advocate Issues

Consumer advocates have been supportive of overdraft protection legislation. The current bills address many of their concerns and contain protections they have sought.⁴ A general concern is that the current automated overdraft protection systems commonly employed by financial institutions can trigger multiple high-cost bank overdraft loans. Fee-based overdraft loans should not be confused with traditional, occasionally employed, and less costly back-up programs for checking accounts that are temporarily overdrawn. Direct deposit, electronic payments, and advances in technology have made it more difficult for consumers to track their account balance to avoid overdrafts. Consumer advocates have urged the Federal Reserve to revise its Regulation Z, which implements the Truth in Lending Act, to require institutions to treat courtesy overdrafts as loans. The TILA disclosures could enable consumers to make more informed decisions and allow comparison shopping. Requiring consumers to actively choose to participate in bounced-check/overdraft protection programs by signing up (opting in) would provide additional protection. Warning notifications at electronic terminals could prevent unintentional overdrafts.

Federal Regulatory Response

Federal regulators of depository financial institutions seek to promote safety and soundness, ensure compliance with laws and regulations, and foster the fair and efficient delivery of services to customers of financial institutions. Federal regulators have issued guidance and revised existing regulations in response to the development of overdraft protection programs.

Guidance Issued by Federal Regulators

In February 2005, federal regulators issued guidance addressing the risks presented by bounced-check or courtesy overdraft protection services. The guidance was issued to assist depository institutions in the disclosure and administration of overdraft programs. The guidance included a best practices list to assist financial institutions in developing responsible disclosure and program administration policies. In general, failure to comply with regulatory guidance may cause regulatory concern that a financial institution is not adequately protecting itself against risk. Two guidance documents were issued; the documents are similar but not identical. On February 14, 2005, the Office of Thrift Supervision issued guidance separately.⁵ On February 18, 2005, joint

⁴ Please see the testimony of Eric Halperin, director, Washington Office, Center for Responsible Lending and Jean Ann Fox, director of Financial Services, Consumer Federation of America. Testimony presented at the hearings can be found on both committees websites at http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr_102309.shtml and <http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.ByMonth&DisplayDate=11/17/09>.

⁵ The press release and access to the guidance document can be found at <http://www.ots.treas.gov/docs/7/77503.html>.

guidance was issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the National Credit Union Administration.⁶ The guidance documents reviewed the safety and soundness concerns raised by bounced-check or courtesy overdraft protection services, and stated that institutions should adopt written policies and procedures to address operational and other risks associated with overdraft programs. The joint agency guidance included an overview of legal risks. Both guidance documents informed institutions purchasing automated bounced-check protection programs from third-party vendors that a due diligence review should be conducted prior to entering into a contract.

Both documents stated that clear disclosures and explanations to consumers of the operation, costs, and limitations of an institution's overdraft program are essential. The guidance highlighted examples of disclosure and marketing practices that raised concern. For instance, some institutions did not clearly illustrate all the types of transactions (ATM withdrawals, debit card purchases, and telephone transfers) besides checks that may be covered by overdraft protections. Some marketing practices appeared to encourage consumers to overdraw their accounts by using the service to meet short-term credit needs. Some institutions did not clearly distinguish how the bounced-check or courtesy overdraft service differed from a traditional line of credit. Other institutions included overdraft protection amounts in the sum they disclosed as the consumer's account "balance" without clearly distinguishing the funds that are available for withdrawal without overdrawing the account.

The guidance provided a best practices list to be taken into consideration by institutions with (or those establishing) bounced-check/overdraft protection programs. The list was divided into two categories: (1) marketing and communications with consumers and (2) program features and operation. Included were clear disclosure of program fees and an opt-out feature. The Office of Thrift Supervision added a best practice: to not manipulate transaction clearing rules to inflate fees.

2005 Amendments to Regulation DD

The Board of Governors of the Federal Reserve System began to study bounced-check and courtesy overdraft services in 2002 to determine the need for regulatory guidance or revisions to Board Regulations. The board solicited public comment and information on the issues. On May 19, 2005, the Federal Reserve issued a final rule amending its Regulation DD to provide consumers with uniform and adequate disclosure information concerning bounced-check or courtesy overdraft protection services.⁷ Regulation DD implements the Truth in Savings Act (TISA),⁸ which requires depository institutions to provide disclosures to enable consumers to make meaningful comparisons of deposit accounts. Regulation DD also contains rules for advertising deposit accounts. The board stated that the revisions to Regulation DD are consistent with the joint guidance issued previously by board and other regulators. Compliance with the amendments to Regulation DD became mandatory on July 1, 2006. Compliance is enforced by the appropriate federal banking agency; failure to comply can result in administrative sanctions.

⁶ The press release and access to the joint guidance can be found at <http://www.fdic.gov/news/news/press/2005/fil1105.html>.

⁷ The press release and access to the final rule can be found at <http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050519/default.htm>.

⁸ 12 U.S.C. 4301.

The board chose to amend Regulation DD because “an overdraft service is provided as a feature and term of a deposit account, and that the fees associated with the service are assessed against the deposit account.”⁹ The board stated that the adoption of these amendments did not rule out a possible future determination that Regulation Z (Truth in Lending) disclosures would be appropriate.

The amendments to Regulation DD addressed account-opening disclosures, periodic statement disclosures, and advertising rules. Institutions must now include in the account opening disclosures required by the TISA the categories of transactions for which an overdraft fee may be imposed. Examples of categories include checks, in person withdrawals, and electronic withdrawals.

New periodic account statement disclosures are required for institutions that advertise their overdraft protection plans. The added information fields are the total amount of fees or charges imposed on the account for paying overdrafts and the total amount of fees charged for returning items unpaid. The added disclosures must be provided for both the statement period and for the calendar year to date. Communications that are defined as advertisements, as well as those that are excluded from the definition, are described in detail. The advertising requirement is also triggered if the periodic statement includes a message stating the overdraft limit for an account; or by disclosing an overdraft limit or including the amount of that limit in an account balance presented on an ATM receipt, an ATM screen, an institution’s website, or telephone response system.

The Regulation DD revisions include changes to advertising rules. Bounced-check/overdraft protection advertisements must include the applicable fees or charges, the categories of transactions covered, the time period consumers have to repay or cover any overdraft, and the circumstances under which the institution would not pay an overdraft. Specific situations are covered where some or all of the added disclosures are not required. In addition, Regulation DD prohibits advertisements that are misleading or that misrepresent the overdraft service. Specific examples are provided in the regulation of what is prohibited.

2008 Amendments to Regulation DD

On December 18, 2008, the Board of Governors of the Federal Reserve System adopted additional amendments to Regulation DD due to continued concerns with overdraft services despite the issuance of the 2005 guidance and Regulation DD amendments. In particular, concern was focused on whether consumers adequately understood the mechanics of how overdraft services operate and the costs of overdraft services. The intent of the recent revisions was to facilitate the ability of consumers to make informed judgments about the use of their transaction accounts. Subsequent to the issuance of the 2008 final rule, the Federal Reserve sought public comment on proposed revisions and gathered research on effective consumer disclosures.

The 2008 final rule¹⁰ requires all institutions to provide aggregate fee information for overdraft services on periodic statements to facilitate the consumer’s ability to make informed judgments about using these services. The information is to include the dollar amounts charged for overdraft fees and for returned item fees for the statement period and the year-to-date. The rule contains proximity and format requirements for the statement fee disclosures.

⁹ Truth in Savings: Final Rule, issued May 19, 2005, p. 8, available at <http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050519/default.htm>.

¹⁰ For additional information on the proposed revisions, see *Federal Register*, vol. 74, no. 18, January 18, 2009, pp. 5584-5594.

In addition, the 2008 final rule addresses account balance information provided through any automated system (including, but not limited to, ATMs, online services, and telephone response systems). Financial institutions are prohibited from including in the disclosed balance any additional amounts of funds that the institution may provide or that may be transferred from another account of the consumer to cover a transaction. The intent of these provisions is to ensure that consumers are provided with an accurate idea of their account balance. The institution would not be required to provide “real-time” balance disclosures. The rule does permit an institution to disclose a separate balance (prominently and accurately identified) that includes the additional funds.

2009 Amendments to Regulation E

On December 18, 2008, the Board of Governors of the Federal Reserve System also proposed revisions to Regulation E. Regulation E implements the Electronic Fund Transfer Act (EFTA),¹¹ which provides for the rights, liabilities, and responsibilities of participants in electronic fund transfer systems. Transactions covered by Regulation E include those made through ATMs, point-of-sale terminals, and remote banking services. The intent of the proposed amendments was to promote consumer knowledge of overdraft protection services and to ensure consumers have the opportunity to limit overdraft costs.¹² The proposal requested public comment¹³ on different approaches to providing consumers a choice regarding overdraft protection coverage for ATM withdrawals and one-time debit card transactions (differentiated from pre-authorized automatic debits) by the account holding institution.

The Board’s consumer testing and review of consumer comments indicated a preference for having an ATM withdrawal or debit card transaction declined if the consumer’s account had insufficient funds to cover the withdrawal as opposed to the institution covering the overdraft and charging an overdraft fee. On the other hand, consumers did want overdraft protection for checks or pre-authorized debits written to cover important bills such as mortgage or rent payments.

On November 12, 2009, the Board of Governors issued final rules under Regulation E.¹⁴ These rules require financial institutions to provide consumers the choice of opting in or affirmatively consenting to the institution’s overdraft program for ATM and one-time debit card transactions. Notice of the opt-in right, an explanation of the institution’s overdraft services, and the costs associated with these services must be provided to both existing and new account holders. Affirmative consent from the consumer must be obtained before fees or charges are assessed. In addition, institutions are prohibited from conditioning the payment of overdrafts for checks or other types of transactions on the consumer affirmatively consenting to the overdraft program for ATM and one-time debit card transactions. Finally, institutions are required to provide consumers who do not opt in with the same account terms, conditions, and features (including pricing) that they provide to consumers who do opt in.

¹¹ 15 U.S.C. 1693 *et seq.*

¹² For additional information on the proposals, see *Federal Register*, vol. 74, no. 18, January 29, 2009, pp. 5212-5243.

¹³ To view the comments received, please see http://www.federalreserve.gov/generalinfo/FOIA/index.cfm?doc_id=R%2D1343&doc_ver=1.

¹⁴ For additional information on the final rule, see *Federal Register*, vol. 74, no. 220, November 17, 2009, pp. 59033-59056.

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